FRIEDRICH EBERT STIFTUNG

THE REFORM AGENDA*

By

Hafiz A. Pasha

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*Derived from the Author's book on *Growth and Inequality in Pakistan*

CONTENTS

LIST OF ACRONYMS

AIT	Agriculture Income Tax
AJ&K	Azad Jammu and Kashmir
BISP	Benazir Income Support Program
BMR	Balancing, Modernization and Replacement
BOT	Build-Operate-Transfer
BPS	Basic Pay Scale
CBN	Cost of Basic Needs
CCI	Council of Common Interests
CCP	Competition Commission of Pakistan
CDWP	Central Development Working Party
CPEC	China-Pakistan Economic Corridor
CPIA	Country Policy Institutional Assessment
DISCOs	Power Distribution Company
ECNEC	Executive Committee of National Economic Council
EOBI	Employees Old Age Benefits Institution
FATA	Federally Administered Tribal Areas
FCF	Federal Consolidated Fund
FDI	Foreign Direct Investment
FLL	Federal Legislative List
FTA	Free Trade Agreement
GDP	Gross Domestic Product
GST	General Sales Tax
HDI	Human Development Index
HEC	Higher Education Commission
HIES	Household Integrated Economic Surveys
HSD	High Speed Diesel
IMF	International Monetary Fund
IPO	Intellectual Property Organization
IPP	Institute of Public Policy
IT	Information Technology
LGO	Local Government Ordinance
MDGs	Millennium Development Goals
MFN	Most Favorite Nation
MNA	Member National Assembly

MPA	Member Provincial Assembly
MW	Mega Watt
NAB	National Accountability Bureau
NCHD	National Commission for Human Development
NEC	National Economic Council
NEPRA	National Electric Power Regulatory Authority
NFC	National Finance Commission
NGOs	Non Governmental Organizations
NICL	National Insurance Co. Ltd.
NIT	National Investment Trust
NCCP	National Clearing Company of Pakistan
NSC	National Security Council
O&M	Operation and Maintenance
OGRA	Oil & Gas Regulatory Authority
OPHDI	Oxford Poverty and Human Development Initiative
P&D	Planning and Development
PAC	Public Accounts Committee
PASMIC	Pakistan Steel Mills Corporation
PEPCO	Pakistan Electric Power Company
PIA	Pakistan International Airlines
PML (N)	Pakistan Muslim League (Nawaz)
POL	Pakistan Oilfields Limited
PPAF	Pakistan Poverty Alleviation Fund
PPP	Pakistan Peoples Party
PSD	Payment Systems Department
PSDP	Public Sector Development Program
PSEs	Public Sector Enterprises
REER	Real Effective Exchange Rate
SBP	State Bank of Pakistan
SDG	Sustainable Development Goals
SECP	Securities and Exchange Commission of Pakistan
SEZs	Special Economic Zone
SLIC	State Life Insurance Corporation of Pakistan
SMEs	Small and Medium Enterprises

SNGPL	Sui Northern Gas Pipelines Limited
SPDC	Social Policy and Development Centre
SROs	Statutory Regulatory Orders
SSGC	Sui Southern Gas Company Ltd.
T&D	Transmission and Distribution
UAE	United Arab Emirates
UNDP	United Nations Development Program
USA	United States of America
VAT	Value Added Tax
WAPDA	Water and Power Development Authority
WPPF	Worker's Profit Participation Fund
WWF	Worker's Welfare Fund

THE REFORM AGENDA

The results of the analysis and principal findings in the chapters of the book have led to the identification of a comprehensive reform agenda, both short-term and medium-term. The focus is first on reviving the real sectors of the economy. This is followed by a set of policies and actions required to stabilize the balance of payments and the public finances of the country. The reform agenda then identifies the root causes of inequality and suggest ways by which these can be tackled. The final part of the agenda highlights fundamental improvements in governance required to support the process of high and inclusive growth in the country on a sustained basis.

The policies required for revival of the economy are identified below:

1.1. REVIVING THE ECONOMY

1.1.1. Agriculture

The top most priority has to be to ensure enough water for agriculture. The emphasis has to be simultaneously on improving water utilization efficiency and on greater exploitation of water resources. The former will require a big enhancement of the water rate ('abiana') to ensure full recovery of the O&M cost of the irrigation system and to facilitate an eventual move towards metering. In addition, the Provincial Governments will lead to implement a greatly expanded program of lining of canals to reduce water losses. Currently, the Government of Punjab, for example, devotes only 8 percent of its ADP to irrigation. This will have to be raised to at least 20 percent.

Appropriate pricing policies will have to be adopted to change cropping patterns away from water-intensive crops like sugarcane towards crops like cotton. Priority will have to be given to promoting use of drip irrigation, with appropriate fiscal incentives and agricultural extension services.

The Prime Minister and the Chief Justice of the Supreme Court of Pakistan have strongly emphasized on the need for construction of dams like Diamer-Basha and Mohmand. There is also the need to resolve the issues related to the construction of the very cost effective Kalabagh Dam.

The terms of trade (ratio of output to input prices) of agriculture must not be allowed to deteriorate. This will require the restoration of minimum support prices, in particular, of cotton and the withdrawal of this support from sugarcane. Also, the price of fertilizer must be kept unchanged of its level in 2017 even if this necessitates a higher subsidy.

The credit availability for agricultural purposes must be enhanced, especially for small farmers. Currently, the share in total advances is 7 percent. It needs to be enhanced to at least 10 percent. A tax credit may be offered to banks for the annual increase in advances to the agricultural sector.

1.1.2. Manufacturing

During the last five years, the average rate of effective protection to domestic import substituting industries has been halved due to the cascading down of import tariffs, with the maximum tariff down from 35 percent to 20 percent. There is strong case for raising the maximum tariff to 25 percent. In addition, the Regional Free Trade Agreement with China has displaced many industries, especially in the engineering goods sector. This is due not only to virtual elimination of import tariffs as part of the FTA, but also by the under invoicing of imports by China. There is a case for setting minimum import prices on some major imports from China and re-negotiating the FTA with more quid pro quo for Pakistan's exports to China.

The loss of export competitiveness of manufacturing sector of Pakistan has to be resorted by maintaining the exchange rate at its true value and not allowing it to appreciate. In addition, since domestic electricity and gas tariffs are above world prices the difference should be reflected in the duty drawback regime.

The industrial sector of Pakistan faces a disproportionate tax burden in relation to other sectors. 74 percent of the tax burden falls on the sector with a share of only 20 percent in national value added. As first steps, a tax deductibility provision must be introduced in the corporate income tax for payments of WWF/WPPF. Second, the minimum income tax on turnover should be withdrawn. As the tax-to-GDP ratio rises, the standard sales tax rate should be brought back to 15 percent from 17 percent.

There is need to provide strong fiscal incentives for revival of investment in industry. As such, the accelerated depreciation allowance on machinery should be raised to 100 percent from 50 percent currently. Also, the tax credit on balancing, modernization or replacement (BMR) should be doubled.

1.2. PROMOTING INVESTMENT

1.2.1. Private Investment

The setting up a new entity requires ease of establishing and doing a business. Pakistan fares very poorly in the international ranking of Ease of Doing Business. It stands at 136 out of 190 countries.

Bank credit has been relatively scarce for small farmers, SMEs and for persons seeking housing mortgages. There is a perception of higher risk of lending in these areas. As such, the provision in the Seventh Schedule of the Income Tax Ordinance for write off by banks against bad debt should be amended. It should now be available only to the above three types of loans and increased to 5 percent.

There is need to reiterate once again the fiscal incentives that are needed for promoting investment. First, the initial depreciation allowance should be raised from 50 percent to 100 percent. Second, the tax credit for BMR should be enhanced to 10 percent. Third, as a step towards simplification and uniform treatment, a standard import tariff of 5 percent only may be charged on plant and machinery and most of the existing SROs on machinery withdrawn.

Special tax holidays need to be put in place for investment in SEZs that are part of CPEC. If a SEZ is located in a designated backward area than the tax holiday may be extended for a period of ten years. Alternatively, SEZs in close proximity to major urban areas may be given this facility for five years.

1.2.2. Public Development Spending

The lack of adequate implementation capacity is a serious issue. This is due primarily to too large a portfolio of projects in both the Federal and Provincial PSDPs. The emphasis must be on timely implementation of on-going projects for realizing on time the development impact and for avoiding cost overruns. New Federal projects should only be undertaken if they are in priority sectors like Water, Power and CPEC.

Top priority has to be given to early completion of transmission and distribution projects to enable fully the utilization of new power generation projects. However, almost 84 percent of the on-going projects are currently to be self-financed by PEPCO and WAPDA and only 16 percent with funds from the federal PSDP. This has led to big implementation delays. Bulk of the T&D projects must be brought into the Federal PSDP. This can be achieved by reducing the largest allocation currently to the National Highway Authority, except for CPEC projects. Also, the focus of the Federal PSDP should be on trunk infrastructure and small intra-provincial projects should be avoided. Further, there should be equal sharing by Provincial Governments in allocations for sectors of joint responsibility like higher education and population planning and health.

An examination of CPEC projects in the Federal PSDP reveals that in a number of cases no Chinese financing has been arranged yet or that the Chinese share in project cost is small. Efforts must be made to secure virtually full Chinese concessional financing for all CPEC infrastructure projects.

Special Federal Programs which either represent forms of pork-barreling or the provision of services essentially in the Provincial domain must be avoided.

Stronger monitoring and accountability arrangements must be put in place to avoid leakages and wastage. There is a strong case for moving to e-procurement to the extent possible.

Efforts must be made to expand the portfolio of projects through innovative arrangements like BOT and PPP.

1.2.3. Privatization Program

The biggest gains from privatization hinge crucially on the presence of autonomous, effective and alert regulatory agencies, free from any political influence and with quasi-judicial powers. In the absence of such regulation, the larger public interest may not be protected. For example, post-privatization commercial banks have raised the margin between the rate of return on advances and deposits. Agriculture, housing and SMEs have been neglected due to higher transactions cost and somewhat higher risk. The performance has instead been on investing in risk-free, high return government paper. The SBP has largely failed in regulating the banks.

A number of criteria should be used to evaluate a candidate unit for privatization to a strategic investor. These criteria include whether the unit is profit or loss-making; whether there is an effective regulator in the sector to which the unit belongs; whether there are large or small liabilities; whether the unit is performing some social function; whether there is large over employment and whether there is strong political opposition and / or resistance from trade unions.

Application of the criteria indicates that the case for privatization is strong in the case of PASMIC, NSC, NIT, SME Bank, HEC and NPCC. As opposed to this, the case is weak in the case of PIA, SSGC, SNGPL, the DISCOs and NICL.

Privatization receipts should not be seen as non-tax receipts 'above the line' in the budget. Instead they should be reported as financing of the budget deficit 'below the line'.

It is important that interests of employees are protected in the process of privatization. A proper severance package must be offered and in the case of sale of Government shares a portion may be allocated to employees, subject, of course, to payment of the reservation price.

1.3. GENERATING EMPLOYMENT

1.3.1. Employment Strategy

The development strategy should focus on sectors which have relatively high employment elasticity with respect to the growth of output. These sectors are construction, small-scale manufacturing, domestic trade and exports, transport and emerging private services.

The plight of highly educated workers in the labor market is visible, with unemployment at almost three times the national unemployment rate. This represents a tragic waste of human capital. A tax credit scheme may be established whereby companies can charge 10 percent of their wage bill on newly employed graduates for two years against their corporate income tax liability. A similar scheme may be offered for the hiring of female workers.

Also, there is need to restrict the expansion in the number of public colleges and universities in the country. The degree programs should focus more on areas where there is greater market demand. The emphasis must shift to secondary education and technical/vocational training.

The growing number of Idle youth to almost 6 million in the country has the makings of a problem of greater social disruption and rising crime. Various youth programs will need to be offered including training opportunities and access to microcredit. In the rural areas, employment guarantee programs of the type in India and a food for work program may also need to be established.

The Government's collects contributions from companies for the earmarked source of the Workers Welfare Fund. However, the receipts on this account have been taken into the Federal Consolidated Fund. This practice must stop. Henceforth, the receipts should be used for payment of higher pensions and for unemployment insurance to workers to the extent possible.

One of the consequences of the large 28 percent devaluation of the Rupee that has already taken place since December 2017 is that wages of Pakistani workers have fallen significantly in dollar terms. This is the appropriate time for Pakistani entrepreneurs to search for a place in the labor-intensive part of global value chains, especially in textiles. A special opportunity is for units in the SEZs, as part of the CPEC, to be oriented towards the Chinese market.

1.3.2. Labor Laws and Conventions

Pakistan has most of labor and human resource laws including those relating to abolition of bonded labor, child employment prevention, minimum wages, worker's welfare fund and prevention of sexual harassment in the work place. The basic problem is effective implementation of the existing laws.

Abolition of bonded labor requires the setting of Vigilance Committees at the district level. A Magistrate is empowered to try summarily any offence related to bonded labor. But such arrangements seldom exist.

A cadre of Inspectors is to be appointed to check if any establishment has employed child workers. The Government must establish Labor Courts, with the function of adjudicating on industrial disputes. The Government must also create Labor Appellate Tribunals. However, few such Courts and Tribunals have been put in place. Further, the law also provides for establishment of a Minimum Wages Board at the Provincial level.

There is need for periodic third-party field survey at the Provincial / district level if the various provisions of different labor laws have been honored.

A major step forward would be the enactment of law relating to gender equality in the workplace, especially for the elimination of discrimination in payment of wages for the same job.

1.4. STABILIZING THE BALANCE OF PAYMENTS

1.4.1. Promoting Exports

Electricity generation capacity has already expanded by 7000 MW in the last five years, due to special efforts by the PML (N) Government. Clearly, highest priority should be given to ensure near zero power load-shedding in supply to export-oriented industries and to avoid any increase in the power or gas tariff paid by these industries.

The backbone of the textile sector is ample supply of domestically produced cotton of good quality at competitive prices. Pakistan had attained the peak production of cotton of 14 million bales in 2014-15. Since then there has been a fall in output of over 16 percent. The target must be get back to the output of at least 14 million bales as soon as possible. This will require a basic change in cropping patterns in the Kharif season away from sugarcane to cotton cultivation. This could be achieved by reintroducing a support price for cotton (phutti), as was the case in the 90s. Simultaneously, the support price on sugarcane may not longer be given. Also, there is a strong case for providing a subsidy to pesticides.

A serious mistake was made from 2014 to 2017 in allowing the real effective exchange rate of the rupee with respect to the US $ to rise to 123. Following depreciation of the currency during the last one year it has come down to 108. This has contributed to some recovery in exports. As a policy, at no stage should the REER be allowed to rise above 100, implying that the rupee is beginning to get overvalued.

Pakistan has introduced a cash export incentive scheme. This scheme needs to be developed in a number of ways. First, it should be paid by the Commercial Banks at the time of export receipts, with no-pre-conditions of minimum growth in exports, etc. The commercial banks can then claim reimbursement from the SBP.

Second, the higher cost of electricity and gas in Pakistan should be reflected in the duty drawback rates. This could add 2 to 3 percentage points to these rates.

Like Bangladesh, the export incentive scheme should also cover more items. Three categories of items may be identified - traditional, emerging and nascent - with the highest rate of incentive for the last category. This will help in diversification of the export base. The total number of items to be covered is 45, at the four-digit level of the HC.

The following sections focus on reduction in the current account and fiscal deficit:

1.4.2. Containing Imports

The trade deficit in goods and services has reached alarming proportions. In 2017-18 it was $36.4 billion, equivalent to almost 12 percent of the GDP. The steps that need to be taken to boost exports of goods have already been described above. The focus here is on containing the level of import of goods and on enhancing exports of services.

Empirical research has highlighted the low price elasticity of imports of Pakistan. This is a reflection of the nature of imports which include essential items like edible oil, tea, pulses, machinery, transport, iron and steel and

POL products. Therefore, this feature of imports has to be kept in mind for designing the appropriate mechanisms for reduction.

In practice, the instruments available are rupee devaluation, higher import tariffs, regulatory duties and cash margins on imports. If Pakistan goes for an IMF Program then the primary mechanism will be a big depreciation in the value of the Rupee. For example, a 10 percent reduction in the level of imports will require devaluation of almost 30 percent and with the full impact accruing with a time lag.

Regulatory duties have already demonstrated their relative inability to control imports in a targeted manner due to under-invoicing and smuggling. There is need to try other instruments like cash margins on all imports of up to 30 percent, with the exception of essential items like POL products, fertilizer and medicines.

Other somewhat unconventional instruments also need to be considered. The first is the setting of tariff quotas as an effective way of controlling the level of import. The MFN tariff could apply to a pre-specified fixed quantity of import, beyond which the import tariff could be doubled or trebled. This could apply to Pakistan's imports of edible oil, exotic foods, transport equipment, automobiles, mobile phones, electronic goods, iron and steel, etc. Many of these items are currently imported from China.

There is significant potential for development of export of services, especially IT services and tourism. As a special incentive the 1 percent presumptive income tax should not be levied on the export of services. Also, IT exports should also be included in the export incentive scheme and appropriate support services provided.

1.4.3. Fulfilling the External Financing Requirement

The balance of payments position has deteriorated to the point where default on external debt repayments is not an unlikely possibility. Already a number of international agencies like Bloomberg have included Pakistan in the list of 10 Countries most prone of default.

The external financing requirement in 2018-19 is projected at over $30 billion in the 'business as usual' scenario. This includes $19 billion of current account deficit and over $11 billion of external debt repayment. Normal flows in the financial account, including those from the multilaterals, bilateral, commercial borrowings, bond flotation and FDI, aggregated to $17 billion in 2017-18. Therefore, the net financing gap is $13 billion, which could be met by a drawdown of reserves. But net reserves with the SBP were down to $9.8 billion at the end of 2017-18. Therefore, in this scenario, default is inevitable and could happen in early 2019. Clearly, there is need for averting this outcome with a very strong set of actions.

The new Government, when confronted with this very difficult and unsustainable situation, first adopted the approach of seeking assistance from friendly countries like Saudi Arabia, UAE and China. Saudi Arabia has had already offered substantial support in the form of deferred payment of $3 billion on oil imports and a deposit of $3 billion with the SBP. There is also the expectation of significant support from China.

However, the Government has opted for seeking balance of payments support from the IMF, the global lender of last resort, irrespective of the level of support from friendly countries. The Fund is likely to ask for a downward adjustment in the size of the current account deficit of over $6 billion. This is likely to be largely predicated on a big devaluation of the Rupee of over 15 percent in relation to the rate of Rs 133.50 per $. This implies that in the next few weeks the Rupee may have to be brought down to below Rs 153 per $.

Following negotiations a number of major changes will also have to be in fiscal policy to bring down the budget deficit to 5 percent of the GDP in 2018-19. In addition, monetary policy will have to be more contractionary in character with a hike in interest rates and restrictions on Government borrowing from the SBP. Also, strong actions will be required to reduce losses in PSEs and notify big increases in power and gas tariffs. The latter step has already been taken.

1.5. MANAGING PUBLIC FINANCES

1.5.1. Tax Reforms

The current tax-to-GDP ratio of Pakistan is 13 percent of the GDP. Research on the size of the 'tax gap' reveals that this is close to 3 percent of the GDP. Therefore, the target must be to raise the tax-to-GDP ratio to 16 percent of the GDP as soon as possible. Direct taxes constitute only 34 percent of total tax revenues and stand at 4.5 percent of the GDP. Therefore, the fiscal effort will need to concentrate on raising revenues from direct taxes by about 1.5 percent of the GDP, equivalent to half the total increase targeted. This will raise the direct tax revenues to 6 percent of the GDP and increase their share in total tax revenues to 37.5 percent.

One important way of raising tax revenues is to withdraw the 'tax expenditures'. These tax exemptions and concessions currently aggregate to over Rs 1 trillion or 3 percent of the GDP. The potential measures include, first, reducing the personal income tax limit from Rs 1.2 million to Rs 800,000 and raising the maximum rate back to 35 percent. Second, there is need to broad-base further the income tax and substantially increase the number of tax return filers. The 2018-19 Budget has precluded non-filers from purchase of a car or a property valued at more than Rs 5 million. This restriction should be extended to the holding of bank credit cards and to consuming of electricity more than Rs 20,000 per month by domestic consumers. Similarly, companies not filing returns should have their licenses revoked by SECP.

Third, the capital gains tax base on securities and property needs to be extended by lengthening the holding period subject to taxation. Fourth, there is need for development of computerized information base to give collateral evidence on big tax evaders. Fourth, the audit policy should be risk-based and cover at least 10 percent of the returns.

Turning to the sales tax there is need for development of a comprehensive and integrated national VAT. This will require harmonization of the federal tax rate on goods and the provincial tax on services. Further, broadening of the VAT will require taxation of manufacturers on the fixed retail price and not on the ex-factory price, in the case of more consumer goods and consumer durables. The sales tax on services will have to be extended to import of services on the basis of the 'reverse charge' principle.

Regarding import tariffs, the need for more effective protection to domestic manufacturers and to help generate more revenue, the tariff wall may have to be raised somewhat at least temporarily The suggested move is to raise the maximum tariff to 25 percent from 20 percent currently. There will then be four slabs of 5 percent, 10 percent, 15 percent and 25 percent. The rates of export incentive / duty drawback will have to be raised accordingly.

Excise duties tax base can be broadened by taxing industries which are in the nature of 'dangerous and offensive' trades as identified in Municipal laws. A key element of tax policy is the tax rates on motor spirit and HSD oil in the event that oil prices continue to rise internationally. Combined together, the rate of GST and the Petrol Levy should be fixed at 17 percent. This will imply somewhat higher taxation of motor spirit and lower taxation on HSD. This is the practice in all other South Asian countries.

1.5.2. Controlling the Budget Deficit

A new area of concern in public finances is the sharp fall in the non-tax-to-GDP ratio. From a peak of 4.9 percent of the GDP it has fallen to only 2.2 percent of the GDP in 2017-18. This is the principal reason why the net revenue receipts of the Federal Government actually fell in absolute terms in

2017-18. The Federal and Provincial Governments will have to raise charges and fees for water, highways, passports, identity cards, postal and telecom services, etc. The rise in oil prices also provides an opportunity for collecting more from royalties on oil and gas. However, there will be greater pressure for raising the tax-to-GDP ratio to compensate for the lower non-tax-to-GDP ratio.

Current expenditure has shown a rising trend and reached a peak of 17 percent of the GDP in 2017-18. The big increase is in Provincial current expenditure which has gone up from 4.8 percent of the GDP in 2012-13 to 6 percent of the GDP in 2017-18. Given the labor-intensity of provincially provided social services, big real increases in salaries, allowances and pensions have had a disproportionate impact on Provincial budgets. There is a case for imposing a moratorium on increase in emoluments for the next two years, except for low grade employees up to BPS Grade 16.

Defense expenditure has gone up by 0.6 percent of the GDP since 2012-13. This was initiated by the war on terror operations in the form of *Zarb e Azb*. Now that terrorism is on the wane, the Defense establishment may consider a voluntary cut in the budget for the Armed forces.

The overhead costs of the Federal Government may be contained significantly by economy in non-salary operating costs of over 2.5 percent of the GDP. In fact, after the 18th Amendment, there is a strong case for 'downsizing' the Federal Government by reducing the number of Divisions / Ministries and undertaking a 'zero base' budgeting exercise of the over 200 Attached Departments and Autonomous Bodies. Grants, which are not mandatory, to Provincial Governments should also be reduced.

Turning to the financing side of the fiscal deficit there has been far too much resort to borrowing from the SBP in the last two years, with downstream inflationary implications. This borrowing should be limited to the extent of 'seignorage' in the national economy of about 1.5 percent of the GDP.

Another major constraint has emerged in public finances of the country. The need to limit the size of the fiscal deficit has led to major cuts in the size of the national PSDP. For example, this was targeted at Rs 2001 billion in 2017-18. The actual expenditure has been Rs 1456 billion, implying a cut of almost 27 percent. Now in the Revised Budget for 2018-19, the Federal PSDP has been reduced once again by 28 percent. This is happening at a time when the requirements of funds for infrastructure are peaking with lumpy investments in dams, upgrading of the electricity transmission and distribution system and CPEC projects. This should increase the pressure to cut back current expenditure to divert more resources for development.

1.5.3. Public Debt Management

Total public debt has been rising exponentially since 2007-08 with an annual growth rate of almost 15 percent. Consequently, the public debt-to-GDP ratio has reached 72.5 percent of the GDP, as of end-June 2018. This is way above the limit imposed by the Fiscal Responsibility and Debt Limitation Act of 60 percent of the GDP.

There have been serious flaws in the management of public debt. During the tenure of the IMF Program, the share of permanent (long-term) domestic debt was pushed up from 23 percent to 37 percent at a time when interest rates were at a peak. Since 2015-16, the trend has been opposite with a shift to floating (short-term) debt. Now, with this overhang of maturing debt at a time when interest rates are rising sharply, the cost of debt servicing is bound to rise sharply.

There is a dire need for strengthening public debt management capacity in the Ministry of Finance. Also, the focus on unfunded debt must increase. National savings schemes should be made more attractive, with wider access, in order to promote household savings in the country. Earlier, the returns on such schemes were brought down for too much. Consequently, the share of unfunded debt has fallen sharply from 33 percent, a decade ago, to less than 18 percent currently.

The next two sections of focus on improving the Federal structure of Pakistan.

1.6. STRENGTHENING THE FEDERATION

1.6.1. Implementing the 18th Amendment

The salient features of the 18th Amendment are, first, abolition of the Concurrent List and transfer of most of the functions in this list to the Provinces. Second, a new list, the Federal Legislative List Part II, has been created of functions which are the joint responsibility of both Federal and Provincial Governments. Third, some additional fiscal powers have also been given to the Provincial Governments. Federal Legislative List Part I has functions to be performed exclusively by the Federal Government.

The planning process ought to change fundamentally after the 18th Amendment. It should become a 'bottom-up' process, instead of the old 'top-down' process. Each Province should prepare its own Regional Development Plan. This should be aggregated by the Planning Commission along with the Federal Development Plan and a consistent Macroeconomic Framework developed.

Following the 18th Amendment a sustainable long-run arrangement in the area of higher education should be as follows:

HEC continues to perform primarily a regulatory function of setting standards and monitoring their adherence. In addition, Federal universities / DGIs will continue to be funded by the HEC.

The 9th NFC Award may make some provision for transfer of additional resources to the Provinces for funding of public universities within their respective domains. Provincial HECs can then begin to perform the financing function. The advantage of this arrangement is that it will separate the regulatory function from financing.

For the first time, there has been recognition of a third tier of Government, the Local Governments. This is articulated in the Article 140A, which states:

i) Each Province shall be law, establish a local government system and devolve political, administrative and financial responsibility and authority to the elected representatives of the local government.

ii) Elections to the local governments shall be held by the Election Commission of Pakistan.

Unfortunately, the local government laws passed by the Provinces have not adhered to 140A, with the exception of Khyber-Pakhtunkhwa. The Supreme Court may wish to ensure that this is done.

The Provinces may be granted more autonomy in the planning process. Only those Provincial projects should come up to Islamabad for approval by the CDWP/ECNEC which either has foreign assistance or cost-sharing by the Federal Government.

There is a proliferation and duplication of 'populist' social welfare programs at both the Federal and Provincial levels. There is need for avoiding this duplication and promoting implementation primarily at the Provincial level.

A number of contentious issues are emerging in the energy sector. It is imperative that these are resolved in the CCI if undue stress on the Federation is to be avoided.

Following the transfer of the sales tax on services to the Provincial Governments, federal excise duties on services must be withdrawn or drastically reduced to avoid double taxation.

In recent years, the Federal Government has been encroaching on various provincial tax bases, leading to over taxation and erosion of these tax bases.

There is need for focusing on development of a national integrated tax system.

Hopefully, the spirit of the 18th Amendment will remain alive and the Federation of Pakistan will find strength from 'Unit in Diversity'.

1.6.2. The 9th NFC Award

The tenure of the 7th NFC Award came to an end in 2014-15. No new Award has been announced since then despite the setting of the 9th NFC. One of the reasons for the delay may have been the absence of a recent Population Census. Such a Census was competed in 2017 and results have been announced.

Clause (d) of the TOR of the 9th NFC is contentious, relating to the allocation of resources to meet expenditures of AJ&K, Gilgit-Baltistan and FATA. These are Federal Territories and should be financed from the Federal share. As such, they do not come under the purview of the NFC. However, following the merger of FATA with Khyber-Pakhtunkhwa the expenditure requirement of FATA will be met through the share of the Province.

There is need for the NFC Secretariat in the Federal Ministry of Finance to update the data on the horizontal criteria, besides population, at the Provincial level. This is essential if any controversy is to be avoided during discussions of the 9th NFC.

The 9th NFC must recognize that following transfers from the Federal Government, the Provincial Governments are fully autonomous in the utilization of their funds. No conditions must be place on the generation of cash surpluses of a particular magnitude unless the Provinces themselves voluntarily do so.

The 9th NFC must complete the process of implementation of the 18th Agreement. There should be agreement on the remaining functions to be transferred to the Provinces and the Award should cater for the cost of these functions to be borne henceforth by the Provincial Governments.

We move on now to proposals for accelerating the pace of human development in Pakistan.

1.7. ACCELERATING THE PACE OF HUMAN DEVELOPMENT

1.7.1. Progress in Human Development

Pakistan does very poorly in the Human Development Index (HDI) of the UNDP. It is ranked 150th out of 189 countries in 2017 and is the lowest country in the group of countries with medium level of human development. Also, it has the lowest ranking among the countries of South Asia

There is a visible slowing down in the trend of social indicators after 2010, despite larger transfers to Provinces, with prime responsibility for health and education, after the 7th NFC Award. The total public outlay on education has increased from 1.7 percent to 2.2 percent of the GDP and on health from 0.6 percent to 1.0 percent of the GDP.

The slow pace of improvement in the HDI despite higher level of public expenditure is the consequence of wrong priorities in budgetary allocation within a social service. Within the education sector a pre-mature transition has been made to higher education with a larger share in allocations. There is need to restore the priority of primary and secondary education with the objective of reaching full net enrolment and thereby largely eliminating the number of out of school children.

Priorities in the health sector are also distorted. A very large share goes to curative health service and a small residual share for preventive programs like immunization, pre-and post-natal care, etc. This has also to be altered substantially.

Efficiency in the delivery of social services has been adversely affected due to bad governance, corruption and leakages. There is need for more accountability of persons delivering the services. This makes out a strong case for local governments to be involved in the management and financing of basic social services.

1.7.2. Meeting the SDGS

The SDGs are substantially more ambitious and more diverse than the MDGs. The number of goals has been expanded from eight to seventeen goals. They include focus on environmental sustainability, industry and employment, reduction in income inequality, strengthening of institutions, etc. There are now as many as 169 targets.

Given the vast number of goals and targets, there is need to prioritize the SDGs in the Pakistani context. Altogether it is recommended that 26 targets out of the total of 169 targets be focused on. The criteria used for selection of the sub-set of targets is, first, the target is essential for achieving sustainable and inclusive growth; second, is already embedded as a target in national planning; third, there is greater scope for achievement of the target with co-operation for multilateral agencies; fourth, where data is available and where achievement of the target has popular appeal.

As such, the chosen targets relate to poverty reduction, reduction in the stunting and wasting of children; decrease in infant mortality, elimination of HIV/AIDS, Malaria and Tuberculosis; achievement of universal primary and secondary education; elimination of gender inequality in basic education; access to safe and affordable drinking water for all and so on.

SDG units need to be established in the Federal Planning Commission and in the Provincial P&D Departments. Efforts must be made with support from the UNDP for estimation of the cost of achieving the targets. This will provide an assessment of feasibility and the level of international assistance required.

The root causes and the extent of inequality are discussed next along with proposals for a more inclusive society.

1.8. REDUCING INEQUALITIES

1.8.1. State Capture by the Elite

The 'elite' is the conglomeration of rich and powerful groups in society. The process by which 'state capture' takes place is by the promulgation of rules, procedures and laws which confer special privileges to these groups or 'vested interests'.

These privileged groups include the feudal class, the military, multinational companies, the bureaucracy, the urban property owners and developers, the trading community, MNA/MPAs and so on.

The feudal class enjoys numerous privileges including a very low income tax, extremely small water charges, input subsidies, high procurement and support prices and low electricity charges on tube wells. The solutions are obvious, including the levy of the AIT at the same rate as non-agricultural income and pricing of output at world prices and inputs at their cost or a subsidy in the case of fertilizer. This faces formidable opposition because of the strong representation of the feudal class in the Assemblies.

The military in Pakistan has diversified its role to areas which do not have a link with the defense of the country. Today, the Army is the owner of the biggest conglomerate of housing societies for the upper income groups and of companies producing a variety of goods and services. The Fauji Foundation and the Army Welfare Trust have assets of Rs 382 billion and net profit of over Rs 30 billion. The Chief Justice of the Supreme Court has said recently that the Army ought to be only involved in low cost housing for the common soldier. Also, the various tax privileges, like the exemption from sales tax in Cantonment Areas, need to be withdrawn.

Multinational companies in Pakistan generally operate behind high tariff walls, set up to attract them. The best example is that of foreign companies assembling and selling automobiles. In addition, there is no vigilance over transfer pricing, especially by pharmaceutical companies. The Chinese companies that have entered Pakistan recently enjoy virtually tax free treatment from all taxes, including income tax exemption of 23 years. The basic principle that ought to be followed is that the difference in treatment of foreign and local companies should not be too large.

Urban real estate developers and owners also enjoy the benefits of very low taxation including hugely under assessed values of rents and capital value for determination of tax liabilities. Influential property developers have either had vast tracts of land allotted illegally or new development of housing schemes at the urban periphery has been kept outside the tax net because of the lack of extension of metropolitan boundaries.

MNAs/MPAs have been to able to legislate generous increases in emoluments for themselves. For example, the annual cost of the National Assembly has more than doubled since 2012-13. A very unusual and unacceptable practice is the allocation of development funds to MNAs/MPAs, which provides scope for big leakage of funds.

Senior bureaucrats skillfully perpetuate and enhance their salaries, pensions and other privileges virtually on an annual basis. Benefits which have been monetized are subject to very low tax rates or exempt. Recently, a huge tax break has been given to salaried tax payers. Senior officers are also given plots in Islamabad at nominal prices.

The list goes on and on of privileges enjoyed by the elite due to state capture. A conservative estimate of the additional income or increase in wealth that accrues annually to these groups is almost Rs 2 trillion. This implies that the tax and other revenue foregone is over Rs 500 billion. The people have to wait for the time, which may never come, when this type of mostly legalized plunder of the State will come to an end.

1.8.2. Inequality in Income and Wealth

Among different sources of income, the most uneven distribution in favor of the top quintile is in property related income, pensions and home remittances. This makes out a very strong case for progressive taxation of rental income and capital value of property. As such, there is need to develop taxes like the property tax, income tax on property income, stamp duty and capital gains tax on sale of property.

There is evidence of substantial underreporting of income by households in the top quintiles in Household Integrated Economic Surveys (HIES). This is indicative of the high levels of income tax evasion in the country. The revenues from the personal income tax could be over twice the existing level if somehow FBR could sharpen its tools for detection of tax evasion.

The most unequal distribution of personal income is in the Province of Sindh and the least unequal in Khyber Pakhtunkhwa. Therefore, the yield of the personal income tax as a percentage of the provincial GDP should be the highest in Sindh.

An important finding is that income inequality tends to increase in the regime of military Governments and becomes more equal in the presence of a democratic system. The likelihood is that the former tend to form an alliance with powerful segments of society to gain legitimacy and extend their rule. Also, higher growth has been observed during the tenure of military Governments with fast development of the modern and formal sectors of the economy. This increases the share of capital income which accrues mostly to the rich. The economic history of Pakistan highlights an important tradeoff between faster growth and more inclusive growth.

Recent years have witnessed a big increase in unemployment rate in the case of highly educated workers and some decline in the case of illiterate workers and workers with education up to the secondary level. This is one of the prime explanations for falling inequality.

The distribution of farm land remains extremely skewed in Pakistan. Only 1 percent of the farmers own over 20 percent of the farm area. A redistribution of land would substantially reduce rural poverty. But land reform is no longer part of the policy agenda. A less radical solution would be the development of a very progressive agricultural income tax.

A new class of capitalists has emerged in Pakistan. These are individuals who realized massive capital gains from ownership and trading of shares, especially during the Musharraf era. This is also a reflection of the failure of the income tax system to adequately tax the trading and capital gains accruing in the Stock Exchanges of Pakistan.

The emergence of inequality is also manifest in the differential access to publicly provided services. In the context of access to education almost 58 percent of the children in the lowest quintile of families have never attended school. This is one of the basic reasons why inequality is perpetuated on an intergenerational basis. Similarly, immunization service providers consciously avoid low income neighborhoods and Katchi Abadis. The spread of major diseases is consequently much higher among children from poor families and the resulting costs incurred are higher. Drinking water through taps is seldom available to low income households in metropolitan cities like Karachi.

The middle class of Pakistan is shrinking, as per an appropriate definition, from 43 percent of the population in 2001-02 to 38 percent in 2015-16. The explanations for this adverse trend lie in the high and increasing unemployment of educated workers and the squeeze on living standards due to rapidly increasing rents and cost of utilities. The Pakistan Tehreek-e-Insaf has been elected on the back of support from the urban middle class. Hopefully, their interests will be catered for more in coming years.

1.8.3. Inter- Provincial Income Inequality

There is a fairly substantial difference in per capita income among the four Provinces of Pakistan as revealed by the estimates of Provincial GDPs and population. Sindh is the only Province with per capita income above the national average, by 22 percent in 2014-15. Punjab, Khyber-Pakhtunkhwa and Balochistan have per capita incomes 4 percent, 6 percent and 45 percent below the national average.

Overall, the evidence is that inter-provincial inequality in income increased sharply in the Musharraf era when Sindh was the fastest growing regional economy with an exceptionally dynamic large-scale manufacturing sector. Inequality has since declined with the emergence of Khyber-Pakhtunkhwa and a relatively better performance of Punjab.

The truly backward Province of Pakistan is Balochistan. It has continued to fall behind. The per capita income of the Province was 26 percent below the national average in 1999-2000. The gap has increased to 45 percent by 2014-15. This probably explains the presence of disgruntled and insurgent elements in the Province.

There is need for understanding the roots of inequality in Pakistan. The 7th NFC Award saw a radical change in the horizontal formula for distribution of the overall share in revenues from the divisible pool of taxes. The shares of Balochistan and Khyber Pakhtunkhwa went up markedly while the big decline was in the share of Punjab.

Why did Balochistan not do better? Perhaps this was due to the burden placed on the regional economy due to Afghan refugees and dislocation of economic activity by more frequent acts of terrorism. In addition, there are issues of lack of institutional capacity for undertaking development activities and also the likelihood of greater corruption by the ruling elite of the Province. The bottom line, therefore, is improvement in the quality of governance in the Province.

Estimation of the sectoral composition of the Provincial GDPs enables the determination of the sectors in which a particular Province has the comparative advantage. Within the agricultural sector, Punjab has a comparative advantage in major crops and livestock; Sindh in livestock and fishing; Khyber Pakhtunkhwa in livestock and forestry and Balochistan in minor crops, fishing and forestry.

Within the industrial sector, Punjab has comparative advantage in large-scale and small-scale manufacturing and in construction; Sindh in mining and quarrying and large-scale manufacturing; Khyber Pakhtunkhwa in construction and electricity and Balochistan in mining and quarrying and gas.

Among, more or less, autonomous service sectors, Punjab does well in public administration and defense, Sindh in finance, insurance and housing, Khyber Pakhtunkhwa in housing and social and community services and Balochistan in public administration and defense.

The Provincial Growth Strategies should focus particularly on development of the sectors in which the Province has the comparative advantage. This will maximize the rate of exploitation of the development potential of the country.

The 9th NFC may need to take cognizance of some important developments. In particular, the absorption of FATA into Khyber-Pakhtunkhwa has some implications. FATA is perhaps the most underdeveloped part of the country, with a literacy rate of 24 percent, well below the national average, and poverty incidence as high as 73.7 percent of the population, according to UNDP [2015]. Therefore, the weight in the horizontal distribution formula of backwardness /poverty may need to be raised from 10 percent in the 7th NFC Award and the overall share of Khyber Pakhtunkhwa increased.

1.8.4. Spatial Variation in the HDI

Based on the methodology developed by the UNDP, the Human Development Index (HDI) of the Provinces and districts of Pakistan has been computed. Sindh Province has the highest HDI of 0.565, followed by Punjab at 0.542, Khyber-Pakhtunkhwa at 0.512 and Balochistan at 0.462. The fastest growth in the HDI is observed in Khyber Pakhtunkhwa and the slowest in Sindh. Therefore, inter-provincial disparities have narrowed in the HDI. However, Balochistan remains at a low level of human development and special efforts will have to be made to raise its HDI to above 0.5.

There are large disparities in the HDI at the district level. Only 3 districts (Karachi, Lahore and Rawalpindi) have achieved a high level (HDI > 0.7) of human development. 21 districts are at the medium level of HDI, with the majority of twelve in Punjab.

The remaining 95 districts are characterized by a low level of human development (HDI < 0.5). 22 of these districts are in Punjab, mostly in the Southern part of the Province. 21 out of the 25 districts of Sindh are relatively backward. This highlights the sharp duality between the urban centers and the rural areas of the Province. As such, the greatest disparity in HDI is observed in Sindh.

Khyber Pakhtunkhwa has even more districts at the medium level of development than Sind. There are 20 out of the 26 districts of the Province at the low level of human development. These districts are spread throughout the Province, with relative concentration in the North. The unfortunate reality in Balochistan is that all 32 districts of Balochistan, including Quetta, are relatively backward.

Provincial Governments will need to have special programs for development of backward districts in their domain. In addition, Federal Agencies like the BISP, PPAF, NCHD and national NGOs must increase their involvement and support to the people in these backward districts.

1.8.5. The Urban-Rural Divide

A methodology has been developed for decomposing the GDP of a Province into its rural and urban components. The urban-rural divide is then the difference in per capita income between the two parts of the Province.

At the national level, contrary perhaps to expectations, almost 40 percent of the value added in industry and 44 percent of services activity is actually in the rural economy. Consequently, the economic base of rural areas is fairly diversified, with the share of non-farm activities at 62 percent. This, of course, also highlights the forward and backward linkages of agriculture with other sectors. Overall, Pakistan is divided into two, more or less, equal parts with 50 percent of the GDP being generated in rural and urban areas respectively.

The presence of diversified economic activities in the rural areas highlights the need for investment in physical infrastructure and spreading the network of services in these areas. Emphasis will, therefore, have to be given to farm-to-market rural roads, village electrification and gas connections besides rural water supply and sanitation, basic education and health services.

There has been some divergence during the period, 2007-08 to 2015-16, between the growth rate of 4.2 percent of the urban GDP and 2.5 percent of the rural GDP. The difference is smaller in terms of growth rates of per capita income of 0.9 percent. This indicates that the pressure for rural-urban migration may not have been as pronounced as in earlier years.

The urban-rural divide is most pronounced in Balochistan with urban per capita income 169 percent above the rural equivalent. This clearly demonstrates the extreme challenge of developing the rural areas of the Province due to low population density, limited availability of water for agriculture and limited human capital. A perhaps unconventional recommendation is to promote the development of a dispersed network of towns and encourage migration to these centres so that some economies of scale could be realized.

A similarly dichotomy is observed in Sindh Province, though of a less intensive nature. Urban per capita value added is twice that in the rural areas. The urban-rural divide is less visible in Punjab and Khyber-Pakhtunkhwa with the gap of 46 percent and 54 percent respectively. As such, these Provinces are less vulnerable to large rural-urban migration. The disparity in both Provinces, especially in Khyber Pakhtunkhwa, has been significantly reduced by the inflow of remittances into rural areas.

1.9. TACKLING POVERTY

1.9.1. Incidence of Poverty

There is considerable controversy about the trend in the incidence of poverty in Pakistan from 2001-02 to 2015-16. More recent data is not yet available.

The cost of basic needs (CBN) approach to draw the poverty line has been adopted by the Planning Commission, according to which the percentage of population below the poverty line fell rapidly from 50.4 percent in 2005-06 to 24.3 percent in 2015-16. Apparently this has happened when the growth rate of per capita income was only 1.2 percent. This implies a high poverty-growth elasticity of minus -5. This is highly unlikely

The SPDC adopts the same CBN approach on the same HIES data sets but comes up with very different results. Poverty incidence is reported to have fallen only from 2001-02 to 2004-05 and then increased significantly from 30 percent in 2004-05 to 38 percent in 2010-11. Thereafter, it has remained constant up to 2015-16.

The big surprise is that with the same approach the trends identified in the incidence of poverty are so different. Perhaps the Planning Commission is under some pressure for political reasons to show sharply declining poverty.

The OPHDI (2015) has made an attempt to resolve the controversy by adopting a different multi-dimensional approach to measure the incidence of poverty. The results also show a downward trend from 2004-05 to 2014-15 like the Planning Commission, but with a significantly lower rate of decline of 1.6 percentage points annually as compared to 2.6 percentage points annually by the Planning Commission.

An attempt at reconciliation based on the use of other indicators leads to the conclusion that there has been some fall in poverty from 47 percent in 2007-08 in 2005-06 to 37 percent in 2015-16. This implies an annual rate of reduction of 1.2 percentage points and a poverty-growth elasticity of-2. However, the absolute level of poverty remains high at 37 percent and a lot more has to be done to alleviate poverty in Pakistan, especially in rural areas where it stands at over 40 percent.

Based on the poverty-growth elasticity of -2, the incidence of poverty is estimated as 32.6 percent in 2017-18. Almost 70 million are still below the poverty line in Pakistan.

1.9.2. Expanding Social Protection

Social protection represents ways of providing support to the poor. There are three types of social protection – social insurance; social assistance and active labor market programs.

The major social assistance programs in Pakistan include the BISP, Zakat and Baitul Maal; price subsidies on basic food items and social protection in the form of pensions to workers provided by the Government or EOBI. The principal labor market program is the provision of microcredit by PPAF and a number of microfinance banks and NGOs. There are also some programs for technical and vocational training.

The total outlay on social protection programs was Rs 624 billion in 2017-18, equivalent to 1.8 percent of the GDP. It has gone up from 1.3 percent of the GDP in 2012-13. The largest spending is on pensions followed by BISP and price subsidies. The share of social insurance is 31 percent, while that of social assistance is 41 percent and 28 percent of employment related programs.

The large number of social protection programs have been evaluated on the basis of a number of criteria including the targeting efficiency, extent of program coverage, ease of access, share of expenditure dedicated to benefits, adequacy of support, income equivalence of transfer, absence of negative incentive effects, extent of self- and progressive finance, degree of independence from private transfers and extent of impact on development.

The three Programs with highest scores are the PPAF, BISP and the Government pension scheme for low grade employees.

The proposed reform agenda includes, first, expansion of coverage of BISP to 8 million families out of the total of almost 11 million poor families. In addition, the monthly supplement needs to be raised by 20 percent to account for inflation. This will raise the budgetary outlay for BISP to Rs 163 billion. In addition, BISP may act as the social platform for conditional cash transfers like sending the girl child to school and child immunization.

Second, the EOBI may consider enhancement of the minimum pension amount and inviting self-employed workers to participate on a contributory basis. Also, a special pension scheme can be developed for Pakistani expatriate workers through the SLIC like India.

Third, persons who qualify with a diploma from accredited technical or vocational training program may be given automatic access to micro-credit. The training should include a module on entrepreneurship and preparation of a feasibility report on a small project.

Fourth, only 10 percent of potential microcredit borrowers are currently covered. A tax credit scheme may be introduced for commercial banks and other financial institutions equivalent to 5 percent of the increase in credit to wholesalers of microcredit like PPAF and Micro Finance Banks.

Fifth, the unemployment rate among graduate or post-graduate youth is high and estimated at 25 percent. There is a dire need for special programs for such youth. These could include internships for these youth with high performance rating in their education. Also, a tax credit of up to 10 percent of the salary and allowances of recently hired graduate youth may be given to employers for the first two years of employment.

The function of 'social welfare' has been transferred to Provincial Governments after the 18th Amendment. Therefore, both Provincial and Federal Governments must cooperate in the design, execution and finance of social protection programs. Programs should ideally be national in character to ensure the same benefit throughout the country.

The recent introduction of the Health Insurance scheme in Islamabad Capital Territory and FATA by the new Government needs to be evaluated carefully if it can be replicated at the national scale.

This final section identifies the required improvements in the quality of governance.

1.10. IMPROVING GOVERNANCE

1.10.1. Governance Scorecard

The World Bank rates countries on the basis of various governance indicators. Pakistan is ranked in the lowest 30 percent of countries in the most indicators including voice and accountability, government effectiveness, regulatory quality and rule of law. It is in the lowest 20 percent of countries in control of corruption. Within the CPIA ratings of the World Bank in the area of economic governance, the poorest rating is in the areas of rule-based governance and focus on removing gender inequality.

A survey of experts, as part of the Governance Report for HEC prepared by IPP (2012), has identified key areas of reforms. First, on the political process and stewardship, there is need for making the structure of political parties more democratic, ensuring that the legislature is more accountable to the public, minimizing decisions by Government on the basis of kickbacks and ensuring that the military is sub-ordinate to the civil Government.

With regard to the relationship between the State and the market the focus mostly is on freeing business transactions from corruption and strengthening the regulatory framework of SBP, SECP and CCP to ensure competitive operation of markets. In the area of dispute resolution two major problems areas identified are ensuring equal access to citizens to justice and establishment of alternative mechanisms for dispute resolution.

A questionnaire was also implemented on a random sample of citizens as a score card on the delivery of services. Within the rural services, the lowest level of satisfaction was reported with services provided by the Police *thana* and the Irrigation department. Similarly, in the urban areas also the Police *thana* was rated very poorly. In terms of quality of residential services, the lowest rating by far was given to gas and electricity supply. Interestingly, the provision of tap water was rated highly throughout the country.

Negative perceptions are common with regard to the operation of public schools and public hospitals. In the case of the former the problems identified are poor quality of teaching and absence of facilities like drinking water and latrine. With regard to public hospitals, the maximum number of complaints was recorded with regard to lack of medicines and testing facility and too many patients leading to very long queues and not enough beds.

1.10.2. Achieving Good Economic Governance

The process of economic policy making needs to be improved. The apex body of the National Economic Council (NEC) must meet every quarter to focus on important issues of policy and reform like export growth, resource mobilization, etc. Prior to this, specific proposals may be examined by a Council of Economic Advisers, chaired by the Prime Minister, including representation of economic exports from outside.

The Planning Commission needs to be converted into an in-house policy think tank of the Government rather than just be a project approval institution.

The process of structural reform, especially involving institutional change, is extremely complex and difficult to manage. It has to be properly planned and executed. Given the limited capacity of the implementing bureaucracy, it is necessary to avoid spreading the reform effort too thin and focusing only on areas where the prospects for success are better or the returns are higher.

There is need to adhere to the norms of good budgeting practices. This includes avoidance of off-budget transactions, showing financing items as revenues, retaining earmarked revenues in the FCF, making large supplementary grants without prior Parliamentary approval, retaining refunds to show higher tax revenues, passing SROs on tax exemptions or concessions without adequate scrutiny, carrying too large a portfolio of projects in the PSDP and so on. Also, the role of the PAC in the National Assembly has to be made more effective as a ‘watchdog’ of financial operations.

An important but seldom emphasized element of good economic governance is consistency in policy making. Reversal of policies under pressure of special interest groups affects the fiat of government. Continuity in policy is essential especially to remove uncertainty in the minds of investors.

Credibility is essential to facilitate the process of economic management. In particular, large-scale manipulation of economic statistics to present a better picture of the economy than is really the case must be avoided. Also, commitments made should be honored like, for example, the payment of tax refunds.

The larger public interest must always be protected. Given the state capture by powerful vested interests any concession leads inevitably to a drain on the exchequer. This necessitates either higher taxation elsewhere or a cutback in expenditure in areas which are generally pro-poor. Alternatively, the Government may resort to excessive borrowing from the SBP, which amounts to printing of more money and higher inflation. This impacts more on the relatively poor.

A major test of good economic governance is the ability to anticipate and manage crises. This requires the presence of early warning systems, quick policy response times and a willingness to take strong actions to mitigate or reduce the impact of crisis. A recent example is the delay by the new Government in taking a decision to go to the IMF in the presence of a balance of payments crisis. Meanwhile, the stock market crashed.

The next requirement is integrity of the political leadership and different echelons of the bureaucracy. Recently the country has been rocked by scandals of large-scale corruption and money laundering by the NAB at the highest level of the Government. There is need to put in strong laws, institutions and mechanisms for greater transparency and accountability. Among the various measures, there is a dire need to promulgate a strong right to Information Act, of the type which already exists in India and other countries.

Effective delivery of services is an important pre-requisite for successful governance. This may not be achieved frequently due to choice of wrong priorities in public expenditure allocations or the adoption of a flawed strategy for delivery of a service. For example, the increased transfer of revenues to Provincial Governments under the 7th NFC Award did not lead to faster improvement in key social indicators. Also, the large losses of PSEs in different sectors are a prime example of failure in effective delivery of services like electricity, gas, railway and air transport.

Finally, an important ingredient of economic governance is the presence of sovereignty in policy decisions. Historically, Government has passively accepted the prescriptions and conditionalities in IMF Programs. Consequently, there has been little 'ownership' of the reform process. The new Government will be starting discussions with the IMF on a new program. It should prepare a well-thought set of 'homegrown' reforms and negotiate for their inclusion in the Program. This will preserve the initiative with Government in the reform process and increase the motivation for implementation.

1.10.3. Vigilant Regulatory Agencies

The role of a number of regulatory agencies which perform functions in the economic domain has been analyzed. This includes the SBP, CCP, IPO, SECP, NEPRA and OGRA. All Regulatory Agencies have been established under Federal Law. But the regulatory function has been placed in FLL-2, according to which this function is the joint responsibility of the Federation and the Provincial Governments.

There are also a number of regulatory authorities under the Provincial Governments, performing functions relating to food, procurement, environment, etc. the Development Authorities at the local level are responsible for land zoning and other related functions in cities.

SBP has engaged in record level of lending of over Rs 1.2 trillion to the Federal Government in 2017-18. This has fuelled inflationary pressures. Aggressive intervention recently in the inter-bank market has led to a faster depletion of foreign exchange reserves. SBP has failed also in ensuring more lending by commercial banks to SMEs, agriculture and housing. Also, the emergence of large accounts with ordinary people for money laundering purposes is a very big failure of regulation.

CCP has largely remained a passive regulator. It has been unable to stop the formation of cartels and restrictive practices in many activities and markets. SECP has had little success in developing a corporate bond market and preventing insider trading in the stock market.

The list of regulatory failures goes on and on of different agencies. It is not surprising that the World Bank ranks Pakistan in the lowest 30 percent of country globally and lower than counties like India, Sri Lanka and Turkey.

In comparative terms, a panel of experts gives the highest ranking to SBP, followed by NEPRA. The lowest ranking is of CCP.

The following reforms are required for improving the performance of regulatory agencies:

i) Regulatory Institutions should be truly autonomous. For example, independence of SBP from the Federal Ministry of Finance has happened only recently. There is need to insulate the agencies from political influence or to capture by special interests.

ii) Appointments of members of the Boards should not be Ministries but by a confirmation process in a Select Committee of the Senate of Pakistan.

iii) There is some ambiguity in the role of the Ombudsman's Office and Regulatory agencies. This should be clarified and roles clearly defined.

iv) Annual Reports of all Federal Regulatory agencies must be presented in the CCI, which in turn presents a report to the Parliament. CCI meetings must be regularly held on a quarterly basis.

v) All Boards of Federal Regulatory Agencies must have representation from each Province.

vi) There is need for technical capacity building, especially of the specialized agencies.

vii) The performance of Provincial regulatory functions needs to be substantially improved, especially in the area of Environment Protection.

Finally, it must be remembered that from the viewpoint of inclusive and sustainable growth, regulatory authorities have a critical role to play.

1.10.4. Establishing Strong Local Governments

The 18th Amendment has formally recognized Local Governments as a legitimate third tier of Government by insertion of Article 140A in the Constitution which states:

> *'Each Province shall, by law, establish a local government system and devolve political, administrative and financial responsibility and authority to the elected representatives of the local governments'*

This was followed by the enactment of Local Government Ordinances by each Provincial Government and elections have also been held. Unfortunately, with the exception of Khyber-Pakhtunkhwa, Article 140A, has not been faithfully implemented.

Three Provinces –Punjab, Sindh and Balochistan - have essentially reverted to the structure of LGO, 1979, with separate Local Governments in rural and urban areas. Punjab has created an Education Authority and a Health Authority in each District with links to the Provincial line departments. In some services, like drinking water (saaf pant), companies at the provincial level have been established.

The role of Local Governments is crucial from the viewpoint of ensuring grassroots participation of the people and creating accountability in the delivery of basic services.

The following reforms are recommended:

i) The Supreme Court may be requested to pass a judgment on whether the Local Government laws of the different Provinces adhere to the provisions of Article 140 A. Accordingly, new laws may be drafted.

ii) Like the Khyber-Pakhtunkhwa Local Government system, the functions of primary and secondary education, hospitals, clinics and public transport should come under the ambit of Local Government, along with the basic municipal services.

iii) The Amendment Order of 2006 on Distribution of Revenues and Grant-in-Aid introduced a special provision whereby Provinces were instructed to transfer the next proceeds of $1/6^{th}$ of sales tax to Local Governments. This amount was to be distributed on the basis of 50.00 percent to Punjab 34.85 percent to Sindh, 9.93 percent to Khyber Pakhtunkhwa (then NWFP) and 5.22 percent to Balochistan. This provision may be considered for incorporation by the 9^{th} NFC in finalizing its Award. This will ensure a flow of at least Rs 300 billion to the Local Governments in the country.

iv) The Provincial Finance Commissions, which are chaired by the Provincial Finance Minister, must have balanced representation of Provincial and Local functionaries. Inclusive of straight transfers, the target should be a transfer at least 30 percent of Provincial revenues to Local Governments.

The new Government of Pakistan Tehreek-e-Insaf is making an effort to introduce a strong Local Government in Punjab, similar to the system already prevalent in Khyber Pakhtunkhwa. This will represent a big change from the present setup which is characterized by little devolution to the local level.

In conclusion, the reform agenda is comprehensive and ambitious. Implementation of this agenda will ensure fast, inclusive and sustainable growth in Pakistan.

About the Author

Dr. Hafiz A. Pasha is Professor Emeritus at Beaconhouse National University, Lahore. He has served as Assistant Secretary General of the United Nations. He has been the Federal Minister for Commerce, Planning and Finance in three Governments of Pakistan. Earlier, he served as Vice Chancellor of the University of Karachi, Dean of IBA and Director of the Applied Economics Research Centre. He has received a number of international and national awards.

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1st Floor, 66-W, Junaid Plaza, Jinnah Avenue
Blue Area, Islamabad, Pakistan

Responsible:

Rolf Paasch
Resident Representative

Abdul Qadir
Programme Coordinator & Advisor

Phone: +92 51 2803391-4
E-mail: info@fes-pakistan.org
Website: www.fes-pakistan.org

To order publication:
info@fes-pakistan.org

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